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Recessions and small business access to credit: Lessons for Europe from interstate banking deregulation in the US

Mathias Hoffmann Iryna Stewen

19 February 2012

Few would deny that there is a strong link between the health of a country's banks and its public finances. With that in mind, this column argues that the banking system can learn from banking deregulation in the US, with knock on effects for Europe's sovereign debt crisis.

The European sovereign debt crisis is often viewed as a banking crisis in disguise (see, for instance, Mody and Sandri 2011 on this site). Policymakers are rightly concerned about the prospect that ever more cautious banks may eventually stop lending to small and medium-sized businesses (or enterprises, known as SMEs). While large firms can tap capital markets directly, SMEs are particularly bank dependent. It would seem that this is true in particular during a recession, when cash flow is low, finance is hard to obtain, and drawing on bank credit lines may be the ultimate way of survival for many small firms.

Given their share of GDP and employment, continued access of small firms to credit markets is also clearly of paramount importance from the point of view of the aggregate economy. One aspect that is commonly overlooked, however, is that SME access to finance is by itself an important element of the risk-sharing mechanisms that alleviates economic asymmetries and ensures the coherence of a monetary union. This column draws on evidence from contemporary economic history – interstate banking deregulation in the US during the 1980s – to argue that overcoming the persistent fragmentation of Europe's banking system could be an important step towards making Europe and the Eurozone more resilient against major aggregate economic downturns in the future.

A well-functioning monetary union relies crucially on mechanisms that help share the fallout of asymmetric business cycle shocks by limiting their impact on consumption and welfare. Such consumption risk–sharing mechanisms may take several forms – labour mobility is one example. Alternatively, integrated capital markets may allow firms and consumers to diversify their portfolios across the member countries of the monetary union, or to borrow from other countries in the case of a recession at home. Finally, fiscal transfer schemes could partly compensate for frictions in capital markets, enabling for some kind of “fiscal smoothing”.

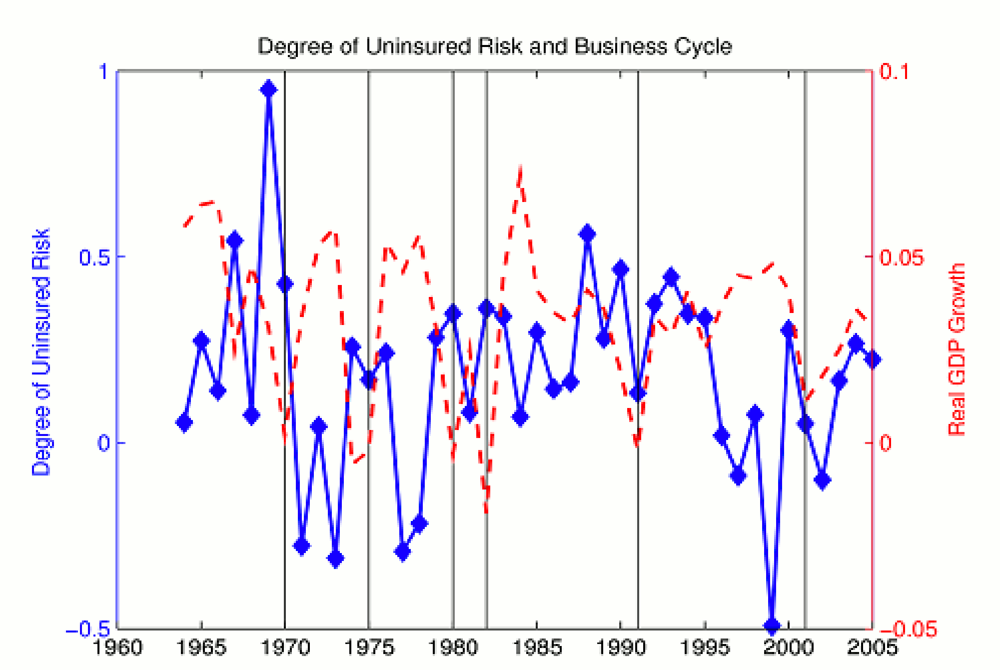
Consumption risk–sharing mechanisms are particularly important in crisis situations and aggregate downturns, as is witnessed by the current situation in Europe – following the EMU's first major recession in 2009, centrifugal forces have gathered momentum; risk-sharing between EMU members does not seem to work in this crisis.
The results of a recent study of ours (Hoffmann and Shcherbakova-Stewen 2011) suggest that widening credit market access for small firms can be important for risk-sharing among the members of a monetary union during union-wide recessions. Our analysis uses the experience of state-level banking deregulation in the US to study how consumption risk-sharing between US federal states varies over the business cycle.

Until rather recently, the US banking system was fragmented similarly to today’s banking systems in Europe – most commercial banks had to be chartered by the federal state in which they were operating. They were not allowed to branch freely within the state, let alone merge with other banks or enter the market in other states. During the 1970s and 1980s, federal states gradually started to abolish these restrictions. This has generated a wide variation in state-level experiences that we exploit in our analysis.

- Our main result is that until the 1980s, consumption risk–sharing between US federal states used to increase in booms and decrease in recessions.
- The second result is that this effect also used to be much more pronounced in states with many small businesses.
- Third, and most importantly, this variation in risk-sharing vanished after a state had liberalised its bank branching regime. This suggests that banking liberalisation improved credit market access of small firms in particular during recessions, and thus contributed to better interstate risk-sharing.

Figure 1 illustrates how risk-sharing varied with the business cycle – there is a pronounced inverse co-movement of our measure of risk-sharing (which is high when risk-sharing is low and vice versa) and US-wide GDP growth. Vertical bars indicate troughs of US-wide recessions according to the NBER classification. It is clearly apparent that, before the mid 1980s, recession troughs used to be associated with high levels of our indicator (which corresponds to low risk-sharing). As we also show in the paper, this pattern of 'procyclical risk-sharing' is particularly pronounced in states where small businesses account for a relatively large share of income or employment, and it is driven largely by a drop in access to borrowing opportunities in credit markets.

Figure 1. Uninsured risk and the business cycle



Notes: The blue, solid line is the coefficient of a sequence of cross-sectional regressions of state-level consumption growth on state-level GDP growth for each year from 1964 to 2005. This is our measure of fraction of a typical state-level shock that remains unshared (i.e. it is 1- risk sharing). The red, dashed line is US aggregate GDP growth. Vertical lines indicate NBER business cycle troughs.

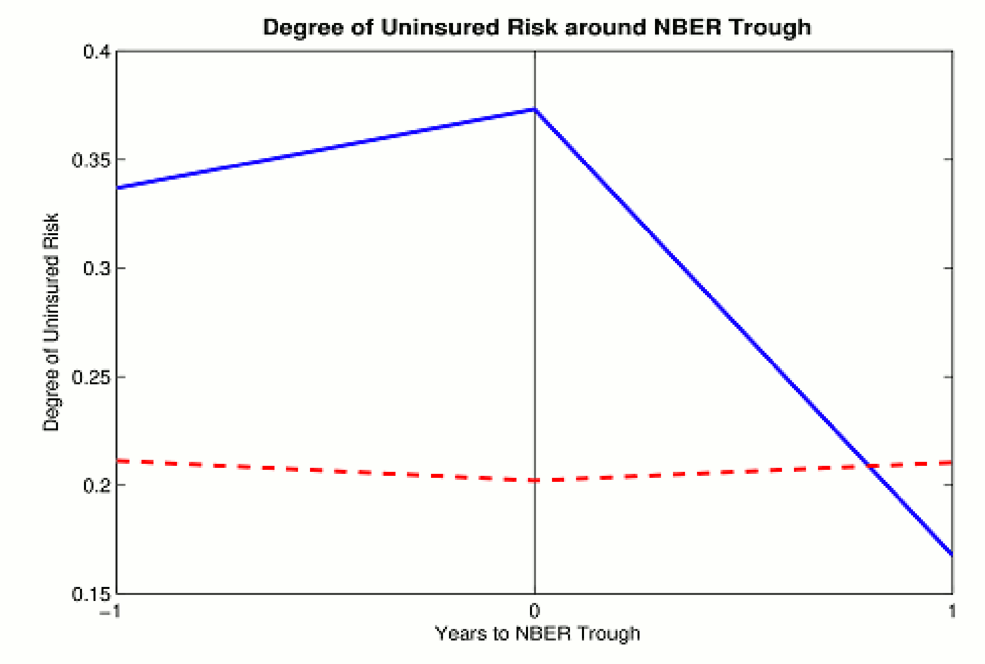
Source: Hoffmann and Shcherbakova-Stewen (2011)

Interestingly, the co-movement between interstate risk-sharing and the US-wide business cycle started to weaken during the 1980s, which is the period during which banking liberalisation at the state level got into full swing (in fact, the correlation between the blue line and the red, dashed line in Figure 1 is -0.44 before 1984 and only -0.13 thereafter).

We show that it is indeed the liberalisation of state bank branching restrictions that is responsible for this weakening. The role of banking liberalisation for risk-sharing is illustrated in Figure 2, which presents the extent of interstate risk-sharing that a state typically achieves in the years around a typical NBER business cycle trough. In Figure 2, we distinguish between two groups of states: Those that had already liberalised in a given recession (red dashed) and those that had not yet liberalised (blue solid line).

The message is clear – for the states that had not liberalised, consumption risk–sharing with other states drops sharply (the fraction of unshared risk goes up in the picture) in a recession, only to recover to 'normal' levels a year after. For the states that have already liberalised during the recession, the extent of risk-sharing with the US as a whole remains stable. In the paper, we then also show that these improvements in risk-sharing overall are actually driven by better access to credit markets (and not some other channel of smoothing or risk-sharing).

Figure 2. Risk-sharing and recessions



Notes: The fraction of risk that typically remains unshared around NBER recession troughs, distinguishing between states that have not yet (blue, solid line) and those that have already (red, dashed line) deregulated.

Source: Hoffmann and Shcherbakova-Stewen (2011)

We believe that these results point towards an important benefit from banking liberalisation: Financial integration facilitates access to finance mainly when it is most urgently needed – during aggregate downturns.

Our results also hold a couple of potentially important lessons for Europe:

- First, the benefits from financial integration may materialise mainly during major recessions.

Note that our results do not suggest that consumption risk–sharing between states had increased across the board following banking deregulation. But they suggest that the improvements in consumption risk–sharing are discernible during US-wide downturns.

- Secondly, overcoming the enduring fragmentation of the European banking system is likely to widen access to credit markets for those sectors of the economy – such as small firms – that are most likely to need most access, in particular in a general crisis situation such as the current one.

Sure, banks in Europe are allowed to set up subsidiaries in other countries relatively easily and direct branching restrictions within Eurozone member states do not really exist. But many of the major lenders to small businesses are confined to operating in a given region only – see, for example, the myriad German *Sparkassen* (savings banks) and *Volks*- and *Raiffeisenbanken* (cooperative banks) – and bank regulation is still largely national.

- Third, the current policy discussion concerning banking regulation in Europe is very much focused on stricter regulation for banks.

Much of this focus is certainly justified. But policymakers should be aware that new regulation, if passed, may effectively amount to a further separation of banking markets along national boundaries. However, it seems that more integration – rather than less – is needed. Small firms are the backbone of all our national economies and so far they have not benefited enough from financial integration at the European level.

For example, to date no pan-European retail bank exists. It is virtually impossible for a French household to obtain a car loan in Germany and for a small Spanish firm to obtain a loan in the Netherlands. It is now time to complete financial integration at the retail level, to allow small firms, their employees, and customers to reap the benefits of financial integration.

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